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IN THE FALL OF 1981, *Euromoney* magazine featured a cover story on how the economies of the noncommunist world had performed since 1973.[1] On the basis of five measures—real growth, inflation, strength of currency, balance of payments, and exports—that together were assumed to "reflect the economic welfare of each economy," the article came up with a ranking of 85 countries for the 1974-1981 period. Not surprisingly, the list was led by three of the so-called newly industrialized countries (NIC's)—Taiwan, Singapore and Hong Kong. The top ten were:

1. Taiwan
2. Singapore
3. Hong Kong
4. Saudi Arabia
5. Malaysia
6. Iraq
7. Egypt
8. Thailand
9. Cyprus
10. Japan

Two general conclusions emerged from the exercise: (1) structurally similar economies—for instance, Mexico and Algeria or Germany and Austria—produced fairly similar scores; and (2) some countries did remarkably better than others that were similarly endowed. In other words, even economies that showed largely similar characteristics to start with and were subject to the same outside influences registered different degrees of economic growth. Such differences, the article stressed, did serve to reveal the importance of national policies in shaping a country's economic performance or, simply, that "domestic policies were responsible for much of the difference."

The importance of domestic policies in shaping economic performance was nowhere more evident than in the reactions of the major industrial countries to the two oil price increases imposed by OPEC in 1973-1974 and in 1979-1980—roughly the same time span covered by *Euromoney's* list. Although differing in absolute amounts, the events that triggered these policy responses were largely similar in nature—namely, a quadrupling and a more than doubling of world oil prices, respectively. But the policies adopted by the industrial countries on the two occasions and the actual results of those policies were sufficiently dissimilar to merit further analysis and exploration.

Obviously, a broad-gauged approach of this kind encounters various hazards and limitations. Countries differ greatly in institutions, markets and policymaking mechanisms so that analysis of a number of countries at once makes treatment of any one of them necessarily superficial. Moreover, an overall approach risks ignoring aspects that are particular to a given country. This report is not intended to convey detailed information on how individual countries acted, but rather to portray how the major industrial countries as a group performed following the two oil shocks.

The Mechanics of Oil Price Increases

Oil price increases have two immediate effects on the economies of oil-importing countries—they reduce growth and worsen inflation. Higher prices for imported oil raise the cost of petroleum products directly and, at the same time, increase the cost of goods and services using oil in their production. This is equivalent to a rise in excise taxes on the affected products and, therefore, consumers suffer a loss of real income. Such a "tax increase" cannot be offset by an increase in money wages, except temporarily, since an increase in wages will lead to a rise in other prices and thus cannot restore real incomes.

In the longer run, of course, the loss in real incomes resulting from the OPEC "tax" need not affect overall demand. To the extent that OPEC's oil revenues are spent on purchases of goods and services in the oil-importing countries (taken as a group), aggregate demand may remain unaffected. This is in fact what happened in 1978 when OPEC imported sufficient goods and services from the industrial countries to offset that year's "tax" in full, and the OPEC surplus virtually disappeared.

In the short run, however, OPEC spending will not increase as rapidly as receipts. This is especially true for the so-called "low absorbers" among the oil producers—countries such as Saudi Arabia and Kuwait that have relatively small populations and hence are unable to respend their oil revenues immediately.

[1] "The World's Best Economies," *Euromoney*, October, 1981.

Among the oil-importing countries, the most immediate and perhaps the most logical reaction to higher oil prices consisted in letting the balance on current account deteriorate, that is, in letting a surplus drop sharply or even turn into a deficit. Germany furnishes the most obvious example of such a development: Its oil imports rose from 1.5 percent of gross national product in 1972 to 5.5 percent in 1981, while the current balance deteriorated from +0.5 percent to −2.0 percent of GNP between those two years.

However, such a deterioration in the balance of payments constitutes a passive accommodation rather than a conscious policy reaction to higher oil prices. There are actually three major ways in which oil-importing countries can react in their economic policies to the "oil tax." (1) They can adopt more expansionary monetary and fiscal policies to offset the drain of that tax on domestic demand, that is, fill the gap in demand by credit expansion and increased deficit spending; (2) they can keep domestic policies unchanged and let the higher oil price exert a dampening effect on domestic demand, with a resulting drop in domestic economic activity; or (3) they can shift their monetary and fiscal policies in the direction of greater restraint. Such action reinforces the deflationary effect of the higher oil price on domestic output but also tends to dampen domestic inflationary pressures.

In general, the response to the 1973-1974 price hike fell into the second category, although some countries, such as the United Kingdom, opted for the first kind of policy action in attempting to compensate for the new OPEC "tax." In 1979-1980, policy response was predominantly of the third kind, as the fight against inflation was given the highest priority.

1973-1974 versus 1979-1980: Some Comparisons

Just as in 1973-1974 (also referred to as "OPEC I"), the steep upward adjustment of the price of oil in 1979-1980 (or "OPEC II"), combined with a simultaneous increase in the prices of major nonoil commodities, generated strong inflationary impulses in the industrial countries. In actual percentage terms, the OPEC II price hike—from $13 to $31 a barrel—looks less severe than that of OPEC I. But such a comparison is misleading because of the relatively low level—about $2.80 per barrel—from which oil prices took off in 1973-1974.

In aggregate economic terms, the increase in the oil import bill of the major industrial countries relative to domestic economic activity was roughly equal in both periods. Although the industrial countries imported some 10 percent less oil (in volume terms) in 1980 than in 1978, the sharp price increase forced them to pay out an extra $150 billion, equivalent to about 2 percent of their combined national incomes. And since the bulk of that amount ended up as addition to the 'petrodollars' accumulated by the OPEC countries—their 1980 current-account surplus reached some $112 billion—the importing countries suffered a deficit (and a deflationary shock) of roughly that magnitude.

However, although the economic impacts of OPEC I and OPEC II were comparable, the actual rise in the prices of oil and of nonoil commodities was somewhat more gradual the second time around. At the same time, the policy reactions of the major countries were more determinedly anti-inflationary. Following OPEC I, some countries had moved to offset the "oil tax"—of some $68 billion in 1974—by expansionary measures at home. These, in turn, resulted in increased budget and balance-of-payments deficits and, often, serious inflationary pressures. In the wake of OPEC II, attempts were, therefore, made to limit the overall inflationary consequences and to encourage the appropriate cost-price relationships.

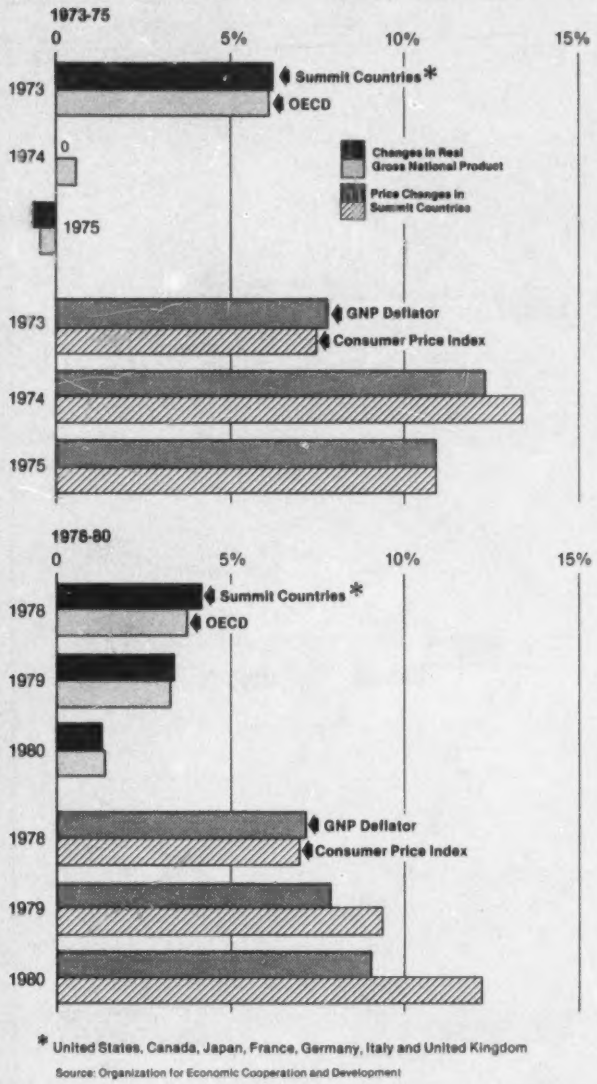
Overall, inflation was somewhat lower in 1979-1980 than in the two years following OPEC I. In 11 major industrial countries as a group, consumer prices rose by about 24 percent during the earlier period as against 20.5 percent during the later one. The concentration of those price rises also differed. During OPEC I, prices soared during the first 12 months of the oil shock, while in 1979-1980 their acceleration was considerably smoother and more protracted.

One favorable factor was that many countries entered the OPEC II period with sharply lower inflation rates than had prevailed at the time of OPEC I. In one group of countries, for instance—including Germany, Japan, Belgium, the Netherlands, and Switzerland—strong policy measures cut inflation rates in half between 1973 and 1975 (from a range of about 7-19 percent to one between 3.5 and 11 percent). During OPEC II, inflation rates among that group rose from 0.5 to 4.0 percent in 1978 to only 4.5 to 7.5 percent in 1980.

Another notable contrast between the two episodes is that the slowing of economic activity in the industrial countries was somewhat less severe the second time around. One reason for this development is that business activity in the major countries was somewhat less synchronized than just prior to the 1975 recession, when most of the industrial countries had reached the end of the recovery phase simultaneously. Thus, in contrast to the United States, where real gross national product fell by 0.2 percent in 1980, Germany and Japan registered GNP growth rates of 1.8 and 4.2 percent, respectively. This decidedly uneven performance resulted in a 1980 growth rate of 1.2 percent for the seven summit countries as a group, which contrasted sharply with zero growth in 1974-1975 (see Chart 1).

This marked contrast between the two episodes has not gone unnoticed. As one author has observed: "The difference in the international mood following the first oil shock in 1974 and the second in 1979

Chart 1: Growth and Inflation, 1973-75 and 1978-80



* United States, Canada, Japan, France, Germany, Italy and United Kingdom

Source: Organization for Economic Cooperation and Development

was. . .striking."[2] As domestic demand and incomes were squeezed for the second time in less than a decade by higher energy prices, the authorities of the industrial countries made no serious attempt to coordinate their policy reactions in order to avert an economic downturn. The most important factor, Shonfield surmises, was that in the intervening five years they had had the rather novel experience of sustained high rates of inflation associated with relatively low levels of economic activity. This "made them nervous about policies which deliberately aimed to give a boost, however temporary, to domestic demand."

In fact, one striking aspect of OPEC II is that the second rise in oil prices was permitted to feed through the system much more rapidly than during OPEC I, when a number of countries had attempted to suppress or postpone the inevitable inflationary consequences. During OPEC II, by contrast, most countries allowed domestic energy prices to increase, so as to reduce dependence on imported energy. Thus, the United States abolished the remaining price controls on domestically produced oil; Belgium adopted special energy-use taxes; and France and Italy introduced sharply higher public-utility charges.

It is essential to realize, however, that only part of the inflation rates experienced by individual countries following the two oil price shocks (and the simultaneous runup in raw material prices) was of external or international origin. Such a distinction between "imported" and "domestically produced" inflation cannot be exact, of course—largely because of the interlinkages and feedbacks between domestic and international costs and prices. To the extent that such a distinction can usefully be made, however, some interesting conclusions emerge.

During 1979-1980, the imported inflation element was stronger in a number of countries than it had been in 1973-1974. These included Italy, Japan and Switzerland, and to a lesser extent Germany and the United States (see Chart 2). Conversely, the domestic inflation component was considerably smaller in most countries in the second period than in the first. In Japan, the domestic element even slowed, despite the country's large dependence on imported energy. In Italy and the United States, on the other hand, domestic inflation rose by as much over the two-year span 1979 to 1980 as it had in 1974-1975.

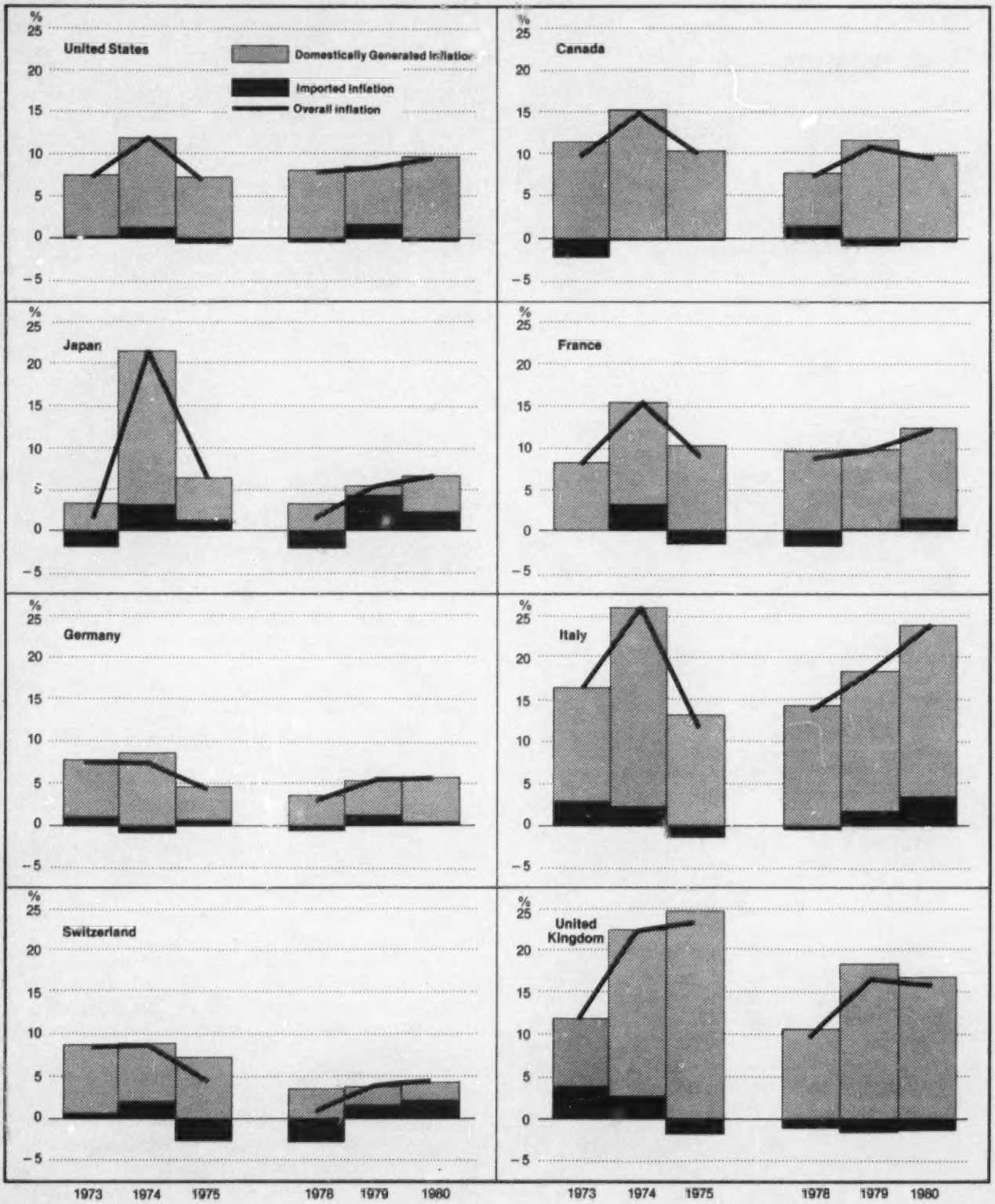
Exchange Rates and Domestic Inflation

Exchange rates have played another crucial role in recent adjustment efforts through the degree to which import prices came to affect domestic inflation. Thus, in late 1973 and in 1974 actual or "natural" import-price increases were magnified in France, Japan and the United Kingdom by the depreciation of those countries' exchange rates. For Canada, Germany and the United States, by contrast, the rise in import prices was dampened to some extent by the appreciation of the two dollars and the German mark.

In the interval between the two oil shocks, diverging exchange-rate movements contributed to marked differences in the way that external price developments were transmitted to national economies. Those movements included the decline of the U.S. dollar from late 1977 on; the appreciation of the yen between 1976 and 1978; the 1975-1976 sterling crisis; the D-mark appreciation

[2]Andrew Shonfield, "The World Economy 1979," America and the World, 1979. *Foreign Affairs*, (Special Issue, Vol. 58. No. 3) p. 607

Chart 2: Components of Inflation, 1973-75 and 1978-80 (annual change in percent)



Source: Bank for International Settlements

between 1976 and 1979; the depreciation of the French franc upon that currency's withdrawal from the European "snake"; and the decline in the Canadian dollar in 1977-1978.

During the second oil price episode, the influence of exchange rates on domestic price movements proved drastically different. In Japan, the 1979 depreciation of the yen made the second oil price increase at least as burdensome, if not more so, than the earlier shock. In the United Kingdom, on the other hand, the sharp appreciation of sterling moderated the external price impact. And France and Germany benefited for a time from appreciating exchange rates.

If we look especially at the price of oil—which is denominated in dollars—the cost of imported oil to a given country will depend both on the world price and on that country's exchange rate against the dollar. Consequently, countries whose currencies appreciated sharply against the dollar in the mid- and late 1970's experienced much smaller oil-push effects on prices and costs than the United States. In certain years, some countries even enjoyed absolute price decreases in domestic-currency terms.

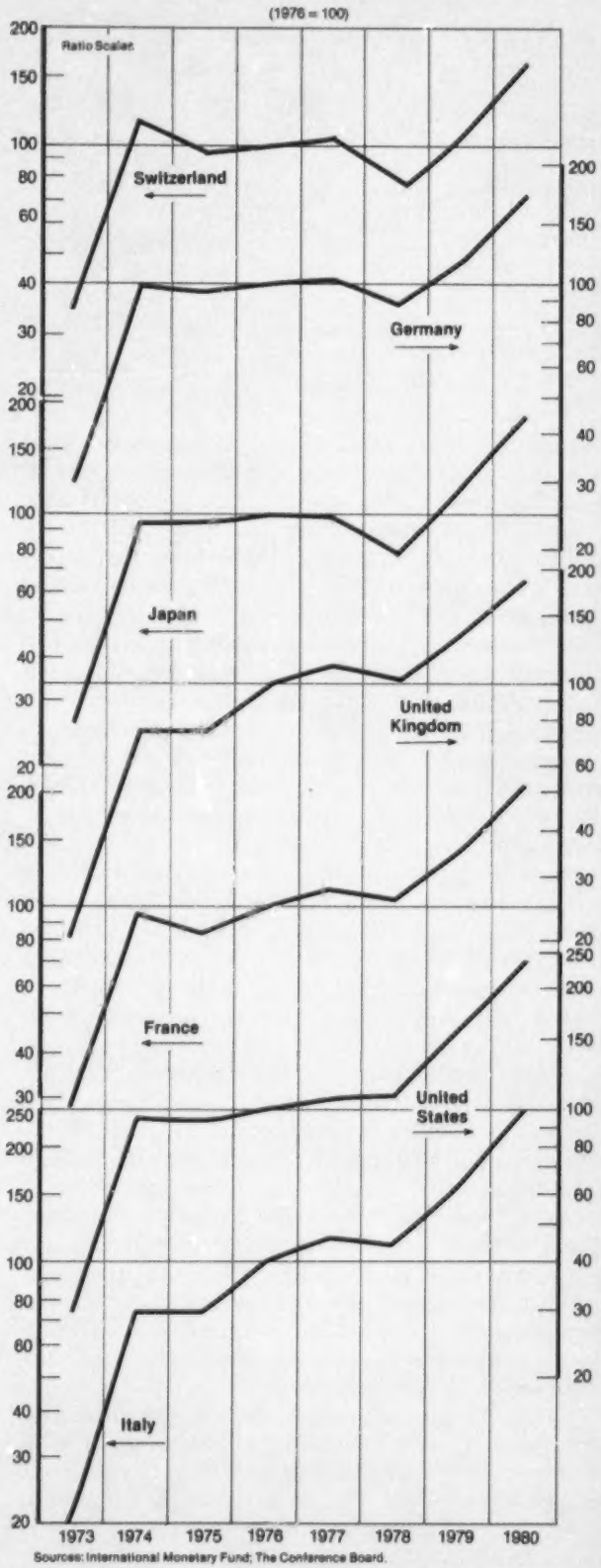
Chart 3 provides data on such cost changes for seven major countries, with the domestic price of oil derived from the world price and the annual average exchange rate against the dollar. While the experience for all seven countries was broadly similar between 1973 and 1974, it began to diverge, often markedly, in subsequent years. Thus, Switzerland enjoyed an absolute decrease in the price of oil between 1974 and 1976 of approximately 12 percent, while the United Kingdom registered an increase of about one-third over the same period. Both Germany and Switzerland benefited from large price decreases between 1976 and 1978.

The stimuli to cost and wage increases arising from the general oil-price hike varied widely, therefore, among countries. In fact, a ranking of major countries by their 1975-1978 inflation rates as compared to their 1970-1973 inflation rates produces an almost perfect correlation with a ranking of those same countries by changes in the domestic price of imported oil (see Table 1). Changes in the domestic cost of imported oil thus provide an important, if partial, explanation of variations in national inflation rates.

Adjusting to OPEC II

The considerably smoother economic adjustment to OPEC II still lacks a full interpretation. The 1981 Report of the Council of Economic Advisers argued that it was not possible "to provide a definitive explanation of why the oil-price rise was absorbed more easily during the current cycle than it was in 1974-75," but then suggested that timing certainly was one of the more important considerations (p. 189).

Chart 3: Domestic Currency Cost of Imported Oil



Sources: International Monetary Fund; The Conference Board.

Table 1: Inflation Rates and Oil Prices

	Ratio of 1975-1978 to 1970-1973 Inflation	Change in Oil Import Price, 1974-1978
	(in percent)	
Italy	+2.4	+49.3
United Kingdom	+2.0	+39.2
France	+1.6	+ 7.3
United States	+1.5	+14.6
Japan	+1.1	—18.1
Germany	+0.8	—12.2
Switzerland	+0.4	—31.6

Sources: H. Peter Gray, "Oil-Push Inflation: A Broader Examination," Banca Nazionale del Lavoro, *Quarterly Review*, March 1981; The Conference Board.

The 1979-1980 runup in oil prices came at a time when most countries were still on an upswing from the previous recession. Thus, in this episode cyclical factors to some extent tended to offset, rather than accentuate, the oil-price shock. Moreover, OPEC I had followed hard on the heels of a major surge in industrial and agricultural commodity prices, leading to strong speculative pressures and excessive inventory accumulation; the second commodity price surge was much less severe. But it has also been argued that the governments of the major industrial countries were about to apply the brakes to economic activity, even before the 1979-1980 oil-price increase became fully effective. The underlying strength of world economic recovery alone would have justified such action.

But subsequently other concerns also seem to have played a role in nudging national authorities toward a more restrictive policy stance. There was, first, the possibility that the 1980 recession in the United States might deepen and, second, that it would coincide with a drop in economic activity elsewhere (especially in the United Kingdom).

In addition, there was the distinct possibility, if not certainty, that the OPEC countries would not be in a position to act the way they had the first time around, when an unrestrained buying spree had quickly eaten into their accumulated oil revenues. Given that some of OPEC's "low absorbers" had completed the initial stages of large, long-range development programs, the prospect was for much larger OPEC surpluses to accumulate. (A related concern was how far, in the wake of the U.S.-Iranian dispute, the owners of the oil funds would be willing to continue entrusting them to the same financial mechanism as before.)

Finally, it is generally felt that a major ingredient in the much smoother economic adjustment following OPEC II was the more restrained response by wage earners in the face of rising prices. This greater restraint contributed toward preserving a relationship between costs and prices that did not impair profitability and, hence, did not inhibit further investment. But it also limited the rise in underlying inflation rates and thus helped reduce the probable duration and severity of the policy-restraint measures needed to deal with the oil price increase itself. In fact, the virtually unanimous (and certainly unambiguous) adoption in most countries of a restraint policy and the rejection of measures that would have financed the oil-price increase had important psychological repercussions on wage negotiations.

In fact, as the Council of Economic Advisers observed in its 1981 report: "In some countries—especially those where the oil-price shock has been absorbed most rapidly, such as Germany and Japan—wage moderation may reflect an implicit social consensus under which unavoidable reductions in real incomes are accepted by wage earners in the understanding that the distribution of income will not thereby be shifted to their disadvantage" (p. 190).

Perhaps the fact that stands out most clearly in comparing the two episodes is that the private sector did not pull in its horns after OPEC II the way it had earlier in the decade. As a result, total demand and output in the industrial countries did not plummet the way they had the first time.

Two major developments can be noted here. First, the more moderate behavior of wages in response to OPEC II permitted business investment to remain fairly strong in a number of countries. While opinion is divided on whether this constituted a fundamental adjustment to the changed environment, it is felt that even if new investment was not specifically directed toward new or expanded energy sources, it nevertheless did include more modern and more efficient energy-related technology.

Partly as a result of the more moderate wage behavior, the share of profits in total activity does not appear to have fallen as sharply as during OPEC II. While comparable national statistics data in this area are difficult to come by, data on price and cost movements and on the share of wages in total factor income suggest a similar conclusion. Thus, while in 1974-1975 the share of labor in national income rose sharply in most countries, that

Table 2: Share of Labor in Domestic Factor Income (in percent)

	1970-1973	1974	1975	1979	1980
United States	77.3	79.3	78.7	79.1	79.6
Canada	72.6	70.6	72.1	69.5	68.8
Japan	56.6	63.0	65.9	65.3	65.0[e]
France	63.9	67.5	70.1	71.1	73.0
Germany	69.2	72.4	72.3	70.8	71.8
Italy	61.1	64.1	68.2	66.0	65.6
United Kingdom	76.0	80.9	82.6	79.8	81.4

Source: Bank for International Settlements.

Adjusting the Japanese Economy

The reasons for Japan's greater success after the second oil price increase seem to have been a combination of cyclical factors, quick and appropriate policy actions, and a willingness among industry and labor to share the economic burden of these increases. When the first price rise occurred in 1973, Japan was experiencing rapid growth, a high rate of capacity utilization, a rapid growth of money, and an extraordinary acceleration in inflation, in part because of a domestic speculative boom. In 1978, by contrast, Japan had a moderate rate of growth, unutilized capacity, and relatively stable prices. Meanwhile the authorities had, in 1978, made substantial progress in shifting the economy toward less energy-intensive and more technology-intensive industries in order to maintain Japan's competitiveness. The moderate nominal wage increases accepted by industry and labor helped to maintain employment and investment levels in spite of the second major oil price rise. Tight monetary policy successfully contained domestic inflation. In addition, a larger depreciation of the yen after the second price rise contributed to a sharper increase in exports and bolstered overall growth.

Walter R. Mahler, "Japan's adjustment to the increased cost of energy." *Finance and Development* (International Monetary Fund), December, 1981

share remained much more stable in 1979-1980 (see Table 2).

Second, the propensity to save generally did not rise, or at least not to the same extent, after OPEC II as after the first oil shock. In 1974-1975, large increases in nominal wages undoubtedly had led to some (perhaps unplanned) increase in savings. In addition, the higher inflation rates prevailing then made for greater losses on the real value of existing financial assets—to which the private sector responded by increased saving (see Chart 4).

Thus, while the private sector cut back its net spending between 1973 and 1975, the second oil shock produced, in many countries, a movement in private spending behavior in the opposite direction. The public sector, by contrast, was not required to support economic activity to the same extent as after OPEC I. These trends can be seen in the consumption and investment patterns of both the private and the public sectors (see Chart 5). All in all, as the Bank for International Settlements has observed, "the shock effect of the first oil crisis was probably greater than that of the second."[3]

Trends in Money Supply and Interest Rates

In the late 1970's the rate of expansion of the money supply declined steadily in most countries outside the United States (see Chart 6). That slowdown was both more pronounced and more protracted than after OPEC I, when the rates of monetary expansion had dropped in both the European Community and Japan by five percentage points in one year (1974), only to increase again during the recession of the following year. This slower growth in monetary expansion was the clear result of the tighter monetary policies pursued in the wake of OPEC II.

But it also reflected (1) the somewhat longer duration of the second oil shock; (2) the more balanced distribution of payments deficits—which tend to reduce domestic liquidity—among the industrial countries; and (3) the fact that during the years immediately preceding the second oil shock monetary expansion had been more restrained almost everywhere than in 1972 and 1973, prior to the first shock.

It should be noted, of course, that for the countries of the European Community the much hoped for and much discussed convergence of price and cost trends—still an illusory goal—as well as maintenance of a system of rigid exchange-rate relationships do not require identical rates of monetary expansion by each of the members. Institutional factors—such as different banking systems and differing definitions of money supply—and structural differences between the economies permit, or even require, divergences in the rates of money growth.

However, as the Commission of the Communities has noted wistfully, the actual divergences between the member countries' rates of monetary expansion in the 1970's "were incompatible with the Community objective of 'convergence in conditions of stability'."[4] These divergences, the Commission comments, stemmed from wide differences in member countries' monetary policies, exchange-rate movements, and inflation differentials.

An approximate guide to the degree of restrictiveness associated with a given stance of monetary policy is provided by real interest rates—that is, the difference between nominal rates and the rates of increase in a price index that can be assumed to more or less reflect the public's expectations on inflation. Such a measure of real rates will, of course, be influenced by the choice of deflator.

For instance, the annual data for the seven largest industrial countries suggest that the increase in nominal interest rates over the past several years did not generally keep pace with the acceleration of consumer prices, but that it more than kept pace with that in GNP deflators. To judge whether real interest rates fell or rose over that

[3]Bank for International Settlements, *Fifty-First Annual Report*, p. 43.

[4]Commission of the European Communities, *European Economy*, July 1981, p. 121.

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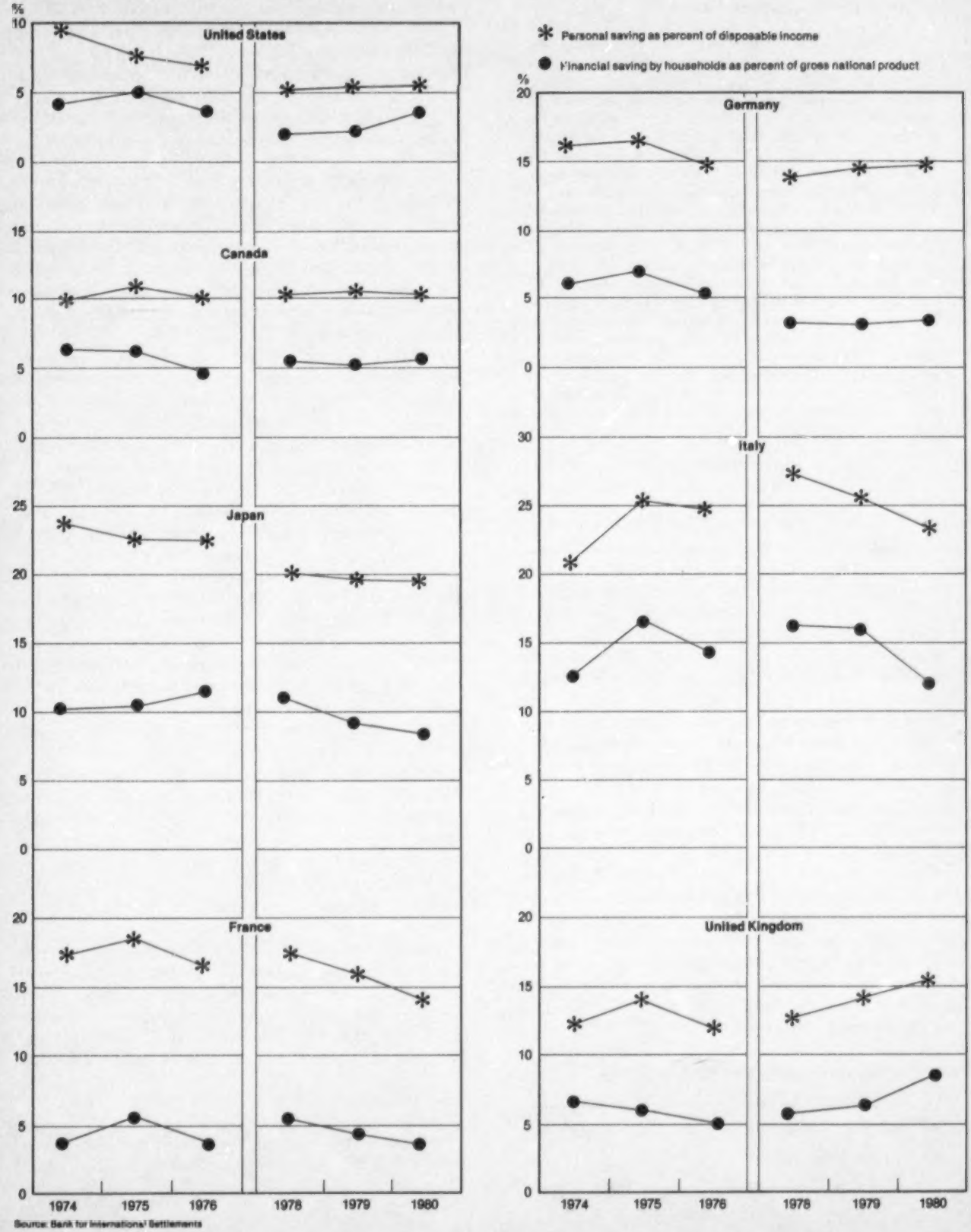
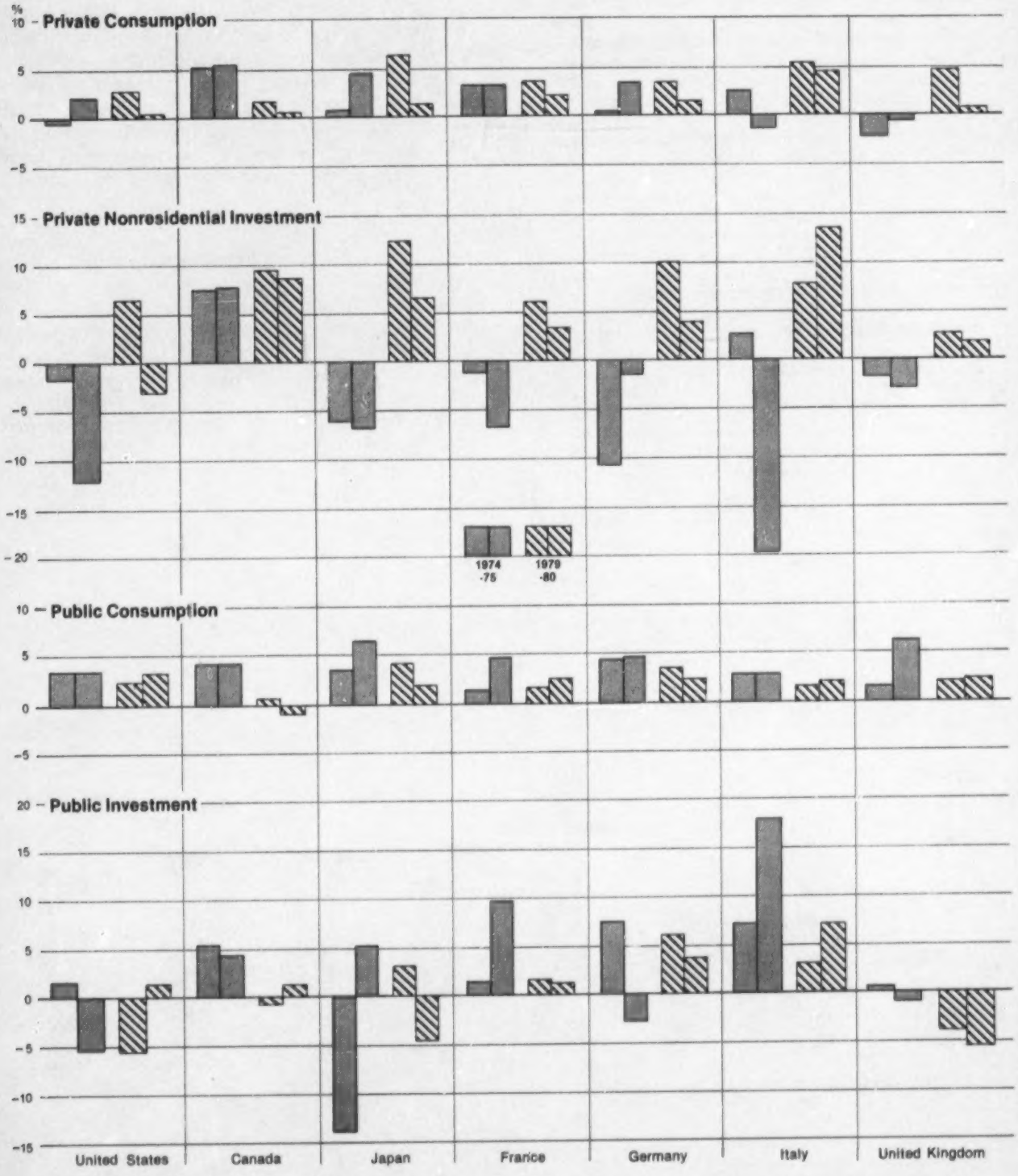
Chart 4: Trend in Saving Rates, 1974-76 and 1978-80



Source: Bank for International Settlements

Chart 5: Consumption and Investment, 1974-75 and 1979-80 (annual change in percent)



Source: Bank for International Settlements

Convergence of European Economies?

[There] is a clear indication that the Member States' economies, underpinned as they are by economic, social and political structures with differing degrees of stability, still respond and adapt quite differently to pressures. Some synchronization of trends in Member States brought about by the growing interdependence of their economies and by the efforts to coordinate their economic policies appears for a while to have masked what are still deep-seated structural imbalances and all that is needed to bring these divergences into sharp relief once again is an external or internal shock. The widening divergences after 1973 stemmed in part from Member States' dependence on crude oil imports, which was more marked in some cases than in others. But it was also attributable to differing social and economic structures that strongly influenced the way in which the burden imposed by the transfer of purchasing power in favor of the oil-producing countries was apportioned between economic agents, with the wage-price link playing an important role here, and to conflicting economic policy views as to the best way of combating this loss of financial means.

Commission of the European Communities,
"The main medium-term issues: an analysis."
European Economy, July, 1981.

(text continued from page 9)

period would, therefore, depend on the choice of price series used to measure inflation.

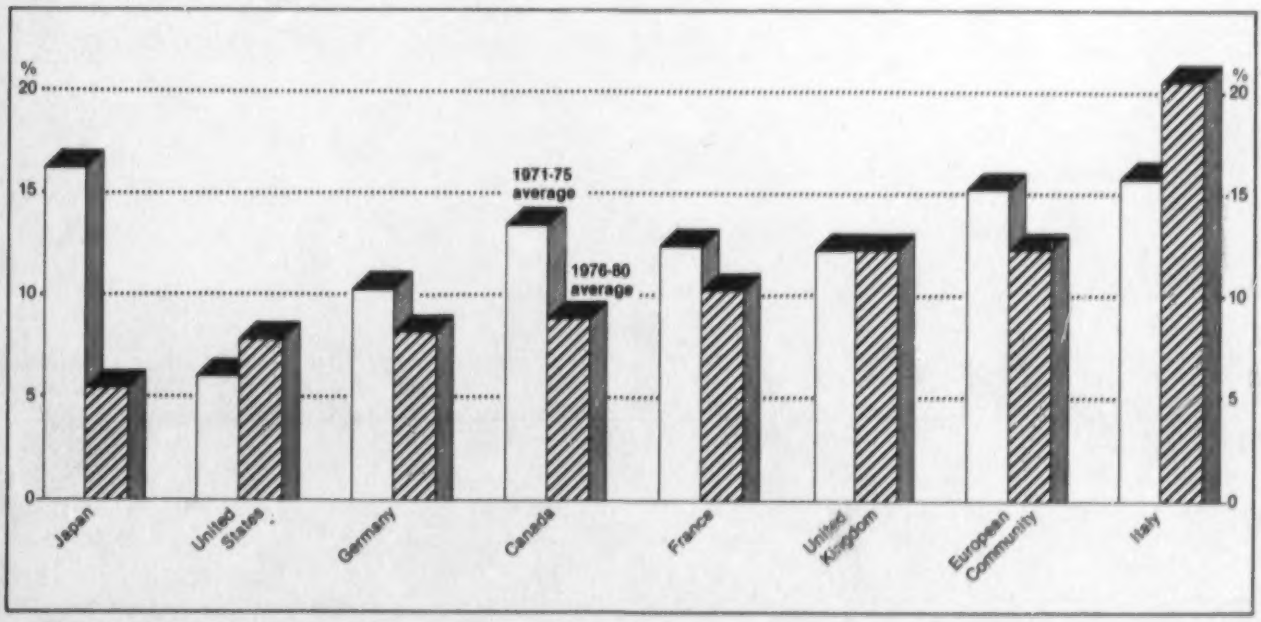
Generally speaking, the average of real rates recorded for the seven countries for 1979-1980 was roughly 2 to 3 percentage points higher than the corresponding average for 1973-1975, regardless of the price or inflation index used. In contrast to the two years following OPEC I, when real rates were negative as inflation quickened, in 1978-1980 these rates turned positive in Germany, Japan and the United States. In France and the United Kingdom real rates were "less negative" than during the earlier episode and actually turned positive by the end of 1980.

The Role of Fiscal Policy

It has been said that in a world beset by stagflation "an assessment of the stance of fiscal policy becomes unusually difficult."[1] In connection with the effects of the two oil shocks it becomes especially interesting (and instructive) to try to chart the course of fiscal policy—to see, that is, to what extent public-sector expenditures may have countered changes in private-sector outlays. But such an assessment becomes unusually difficult indeed if it is realized that, over the past ten to fifteen years, growth in budget expenditures in most countries has

[1]Bank for International Settlements, p. 35.

Chart 6: Growth of Money Stock* (in percent)



* M_{1B} for United States and M_1 for other countries
Sources: Bank for International Settlements; Commission of the European Communities

Table 3: Central Government Fiscal Balances (as percent of gross national product)

Year	Canada	United States	Japan	France	Fed. Rep. of Germany	Italy	United Kingdom	Belgium	Nether-lands	Sweden
1973....	0.3	—0.4	—5.2	0.6	0.5	—8.3	—3.1	—2.9	0.3	1.8
1974....	0.7	—0.7	—5.8	0.3	—0.7	—7.5	—4.2	—2.8	—0.6	0.2
1975....	—2.3	—4.9	—8.9	—3.0	—3.6	—10.7	—8.0	—4.7	—3.1	0.1
1976....	—1.8	—3.4	—8.3	—1.1	—2.8	—9.[illegible]	—5.5	—5.0	—3.6	2.1
1977....	—3.6	—2.6	—7.3	—1.1	—2.2	—9.0	—3.1	—5.9	—3.1	—0.8
1978....	—4.8	—2.0	—9.2	—1.3	—2.1	—13.1	—5.1	—6.0	—3.3	—4.0
1979....	—3.5	—1.2	—8.9	—1.1	—1.9	—10.8	—5.5	—6.5	—4.4	—6.1
1980....	—3.7	—2.6	—8.6	—1.3	—1.8	—10.7	—5.0	—8.2	—4.8	—6.6

Source: International Monetary Fund

served not so much to support traditional activities and the general economy, but "the provision of health, social security, and welfare and, to a lesser extent, of education."[6]

Still, after OPEC I offsetting action to cushion the decline in private-sector spending can clearly be discerned in most countries. But it is worth noting that, with the exception of the United States, this deterioration generally was not reversed. In fact, in some countries—including Belgium, the Netherlands, and Japan—the central government deficit has tended to grow further as a percentage of gross national product (see Table 3).

It is precisely because of the persistence and continued growth of these deficits that it has become so difficult to define what the stance of fiscal policy really has been. In other words, one must ask to what extent these deficits can be seen as simply compensating for high-private sector saving and oil-related payments deficits. It is generally agreed, moreover, that high deficits complicate the task of monetary authorities, through their effects on interest rates and financial markets. In short, because of this particular fiscal-policy configuration, monetary policy generally has had to be very much tighter than otherwise would have been the case—and has had to be maintained tight much longer.

This dilemma was alluded to by Governor Wallich of the Federal Reserve before the American Economic Association last December. Mr. Wallich declared: "Fiscal policy in most countries is not part of the solution, but of the problem. Monetary policy has to do both the domestic and the international job, to the extent that one can pursue two goals with one instrument."[7]

[6]Commission of the European Communities, p. 134.

[7]"The Federal Reserve and Interest Rates." Remarks by Henry C. Wallich, Member, Board of Governors of the Federal Reserve System, at a roundtable on "Monetary Policy and the International Impact of Interest Rates" at the annual meeting of the American Economic Association, Washington, D.C., December 28, 1981, mimeographed, p. 8.

It is possible to illustrate this dilemma more clearly by juxtaposing measures of tightness or ease of both monetary and fiscal policy. One author has done so by comparing the so-called yield curve—that is, short-term interest rates divided by long-term ones—and the public-sector deficit as a percentage of gross national product for both the United States and the United Kingdom.[8] By plotting in four quadrants the four possible combinations of easy and tight fiscal and monetary policies (tight-tight; tight-easy; easy-easy; and easy-tight), he finds over the entire postwar period only one observation—1969—of tight monetary *and* tight fiscal policies for both countries.

The vast majority of his observations lies in the quadrant representing easy money and easy fiscal policy. Both policies appear to have eased markedly throughout the early 1970's; the main tightening, when it did occur, was through monetary policy. The second half of the 1970's again saw a marked easing of both sets of policy, with the tightening since 1979 again carried by monetary measures alone. (The four episodes of easy monetary and tight fiscal policy in the United States occurred in 1951, 1956, 1957, and 1960.) Moreover, the extent of combined ease has been greater in the United Kingdom, explaining the greater inflationary experience of that country.

The Pattern of External Accounts

An important development during OPEC II, with a strong bearing on the stance and direction of policy, was the different distribution of payments imbalances from what they had been at the time of OPEC I. The second time around, deficits were concentrated to a much greater degree among the major industrial countries. Some of these were direct recipients of capital inflows from

[8]Richard Coghlan, "The conflict between monetary and fiscal policy," *The Banker*, October, 1981.

Changing the Policy Mix?

A theoretical solution to the policy conflict between monetary and fiscal measures is suggested in a recent analysis that visualizes a world in which both monetary and fiscal policy could serve as flexible and efficiently managed tools.[1] In such an ideal world, the argument goes, it would be preferable to assign to fiscal policy the job of looking after domestic stability while monetary policy concerned itself with the balance of payments or the exchange rate.

According to that analysis, a combination of tighter monetary policy and a more expansionary fiscal stance will lead to an increase in domestic interest rates, an inflow of capital, and an appreciation of the country's exchange rate, reducing its trade surplus (or increasing its deficit). The country's trading partners, it is argued, will experience outflows of capital, depreciation of their exchange rates, reduction of their trade deficits (or increases in their surpluses), and hence an expansion of demand and incomes.

The opposite policy combination—monetary expansion accompanied by fiscal restraint—would produce the opposite effects: an outflow of capital and depreciation of the exchange rate, thereby shifting demand away from the goods of the country's trading partners and reducing total demand and incomes in their economies.

Such a policy-mix prescription implies the adoption of measures that do not operate in conflicting directions on the domestic economy and thus do not hamper the authorities' ability to "fine-tune" their stabilization policies. But it suggests—perhaps somewhat blindly to existing realities—that fiscal policy, rather than monetary policy, be used as the main instrument of steering domestic economic activity.

[1]Rudiger Dornbusch and Paul Krugman, "Flexible Exchange Rates in the Short Run," *Brookings Papers on Economic Activity*, 1976, No. 3.

OPEC, while others were well placed to finance their deficits in other ways. Moreover, in 1980 as much as two-fifths of the industrial countries' combined payments deficit was borne by Germany and Japan alone (see Table 4).

In the changing global pattern of payments balances after OPEC II, two other aspects stand out. First, for all oil-importing countries—both industrial and developing—the typical current-account deficit in the early 1970's was around 3 percent of gross national product. This share reached 6 percent in 1974-1975 and rose further to over 7 percent in 1980-1981. On the other hand, for the smaller industrial countries and many of the nonoil developing ones external deficits in 1980 were smaller in relation to export earnings than after OPEC I. This was true despite the sharply increased size of these countries' external indebtedness and the higher cost of servicing that debt.

A second feature of OPEC II was the appreciation of currencies with high domestic inflation rates, particularly the dollar and sterling, and the depreciation of currencies with low inflation rates, such as the D-mark, the Swiss franc, and, briefly, the yen. These parallel developments—which in some instances antedated OPEC II—tended to weaken the international competitive positions of high-inflation countries and to strengthen those of low-inflation countries. (A deterioration or improvement in a country's international competitive position is indicated by a stronger upward or downward movement in its exchange rate than in its costs and prices.)

Three main factors appear to have been at work in bringing about such divergences between exchange rates and cost and price movements. First, in a number of cases earlier exchange-rate movements had assumed such substantial proportions that there was little margin for expectations of further movement in the same direction. Witness the substantial appreciations of the D-mark, the Swiss franc, and the yen, which by 1978-1979 had risen by 60, 103 and 45 percent, respectively, since the end of 1972. At its low point in late 1978, the dollar, for its part, stood some 20 percent below its end-of-1972 level. Partly as a result of these sharp one-way swings, these four currencies all experienced substantial turnarounds in their payments balances.

A second factor that contributed to differences in exchange-rate movements from international inflation differentials was that Canada, the United Kingdom, and the United States—three countries with high inflation rates—all happened to be favorably placed with respect to domestic oil supplies. In the United States, this factor was reinforced by decontrol of domestic oil prices.

Third, the movement of exchange rates was influenced in both the United Kingdom and the United States by the adoption of more determined anti-inflationary policies. These relied heavily on tighter domestic monetary controls and thereby put strong upward pressure on domestic interest rates which, in turn, widened the interest-rate differential in favor of those countries.

To complete the policy record of the OPEC II period, it is worth noting that even when their currencies were appreciating, Germany, Japan and Switzerland took measures designed to reduce domestic demand. Such actions ran counter to the standard textbook axiom that exchange-rate changes will have the desired effects on the balance of payments only if they are accompanied by appropriate domestic policy measures. In the context of an appreciating currency, this would mean expansionary measures to stimulate domestic spending. But since these three countries' primary objective throughout the period was to avoid inflation rather than to reduce their payments surpluses, appreciation of the exchange rate was seen by them as aiding the former rather than the latter goal.[9]

[9]For a discussion of this point, see David Higham, "Strong Currencies and Economic Performance: Lessons from Germany, Japan and Switzerland," *Three Banks Review*, Edinburgh, June 1981.

Table 4: Current-Account Balances (billions of dollars)

	1973	1974	1975	1976	1977	1978	1979	1980
Industrial countries	19.3	−12.4	17.1	−2.1	−5.5	30.1	−10.7	−44.0
United States	9.9	7.6	21.2	7.5	−11.3	−11.1	2.8	8.4
Germany	7.1	13.0	7.7	7.7	8.5	13.5	0.9	−8.5
Japan	0.1	−4.5	−0.4	3.9	11.1	18.0	−8.0	−9.5
Oil-Exporting countries	6.6	67.8	35.0	40.0	31.1	3.3	68.4	112.2
Nonoil developing countries	−11.5	−36.8	−46.5	−32.9	−29.6	−37.1	−56.1	−80.4

Source: International Monetary Fund

Concluding Remarks

In its latest (1981) annual report, the International Monetary Fund pointed out that, while the world economic situation might be fraught with problems and difficulties, "any balanced assessment must also take note of certain positive or encouraging aspects" (page 36). Among the latter, the Fund underscored the fact that the industrial countries' policy response to OPEC II was so much better than in the case of OPEC I, and that the ensuing adjustment, therefore, proceeded more smoothly.

As this report has made clear, there was a striking difference between the reaction to the two oil-price hikes and, as a result, between the ensuing economic adjustments. In the wake of OPEC II, monetary policies were generally more restrictive, wage increases remained more restrained, profits were squeezed less severely, investment tended to hold up better, and the repercussions of the higher oil price on the overall price level were more limited. In view of all this, the Organization for Economic Cooperation and Development was able to conclude last December that "the demand-depressing effects of the 1979-80 oil price rise now seem largely to have worked themselves through."[10]

However, it is indisputable that, even with the effects of OPEC II largely assimilated, the industrial countries' major problems—slow growth and high inflation rates—will continue. This would seem to argue that the two oil-price increases of the last decade, and particularly that of 1979-1980, cannot be blamed for all of our current ills. Some observers, in fact, have criticized the authorities for allegedly contributing to the depth and duration of the current recession by overreacting to OPEC II, and thereby making things even worse.

It is, of course, moot to argue what the course of economic activity in the major industrial countries might have been had policies been different. This is especially true at the present juncture when there is such profound disagreement over the effects of various policy mechanisms and their timing. But the "positive or encouraging" results of recent policies must include the noticeable slowing down of inflation in late 1981 and early 1982. These lower inflation rates have also reflected more moderate food price increases following good harvests and softer commodity prices as a result of slacker demand. Moreover, with unemployment high and (presumably) a heightened understanding that real-income losses from high oil prices had to be accepted, wage demands remained moderate in 1980 and continued to remain so in some countries last year.

It will be especially interesting to track the course of economic activity now that oil prices have begun to decline not only in real, but even in absolute, terms. It is extremely unlikely that this development by itself will help overcome the problem of "stagflation"—that is, the combination of high inflation, slow growth, and high unemployment that was built up in the 1960's and 1970's. Because that economic disease, "a rare malady that had not previously afflicted the industrial West,"[11] was fully recognized and diagnosed at about the time OPEC first flexed its muscle in the winter of 1973-1974, many observers have been tempted to lay our current problems largely at OPEC's door.

But a closer look suggests a different conclusion—namely, that the most important causes of stagflation are not external. These include the expansion of government and of government regulation; the indexation of incomes; declining productivity growth; and protectionist tendencies, to name only a few. It is highly likely that at least some of these factors will still be with us at a time when both OPEC I and OPEC II will have become no more than interesting and instructive exercises for students of international economics and finance.

[10]Organization for Economic Cooperation and Development, *Economic Outlook*, December, 1981, p. 5.

[11]Harold van B. Cleveland, and Thomas F. Huertas, "Stagflation: How We Got Into It—How To Get Out," *Foreign Affairs*, Fall, 1979, p. 103.